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SUBJECT: SHIPYARDS ALBATROSSES OF CROATIAN ECONOMY

¶1. Summary: Of Croatia's loss-making, unreformed industries, none is more politically sensitive or costs the country's taxpayers more than shipbuilding. With a total of six major shipyards on the Adriatic coast, shipbuilding is a key employer in many communities and an important component of Croatia's exports. However, the small size of the yards, coupled with their chronic inefficiency, poor management and relentless Asian competition results in annual losses in the hundreds of millions of dollars being covered by the state. The European Union has warned Croatia that these subsidies violate the EU's competition regulations and the GOC will have to eliminate them to close this chapter of its accession negotiations. The government so far has shown no indication that it will swallow this bitter pill. In fact, with elections set for 2007, it appears set to ignore the advice of its own consultants and continue to dole out

guarantees to these industrial relics. End Summary.

Glorious Past; Grim Present

¶2. As much as Croatia's shipbuilding industry is a testament to Dalmatia's rich maritime history, today it is but a rusty and costly reminder of the more recent industrial past. Croatia has six major Adriatic shipyards: Uljanik in Pula, 3 Maj and Viktor Lenac in Rijeka, Kraljevica, Trogir and Split. Together, the shipyards directly employ about 12,000 workers and, according to government estimates, account for an equal amount of indirect employment.

¶3. Despite the fact that all of Croatia's shipyards have orders on the books for the next several years, all lose money. With sales last year worth approximately \$700 million, the shipyards received subsidies in various forms worth nearly \$500 million. The reasons for the chronic losses are many, but even excluding poor management and inefficiency, the industry faces a difficult competitive environment. During a recent visit, the CEO of Rijeka's 3 Maj told econoff that, despite a doubling of productivity and reduction in delivery times, Croatian yards, which can deliver 5 or 6 ships annually face competition from yards in Asia that turn out upwards of 60 vessels every year. 3 Maj sees salvation in moving up-market into more sophisticated vessels than the relatively low value-added tankers it currently produces, but competition is not static either.

¶4. Compounding economic woes are steep rises in the price of steel and the decline of the US dollar against other major currencies over the last few years. A legacy of designed economic interdependence in the former Yugoslavia, Croatia does not produce any of the steel that is the main input for its ships, despite the fact that it has two loss-making state-owned steel works. Steel is imported from Macedonia. Such is the case with many other inputs. In fact, a total of 80 percent of the value of every ship is imported and priced in euros. Delivered ships, however, are priced in dollars in contracts concluded years before delivery. This double blow from exchange risk (which management failed to hedge) on the back of higher steel prices has hit the industry especially hard.

Nostalgia and Local Politics Thwart Reform

15. The problems of Croatia's shipyards are well-known in the country, yet any discussion of reform is inevitably prefaced with a promise to keep all yards operational. Pre-emption of the option of closing one or more of the shipyards means that the only course left for the government has been to throw good money after bad in a futile effort to bring the industry to profitability. GOC officials never cease to point out the importance of ships in Croatia's dismal balance of trade in which exports cover only 47 percent of imports. Ships alone account for 15 percent of Croatia's exports, although their large import content is rarely mentioned.

16. Jobs are the political boogeyman of reform. Few politicians in a country with an unemployment rate over 12 percent want to give a pink slip to several thousand people, to say little of the further dislocations in local economies where the yards are based. Ironically, however, the jobs issue is not so clear cut. When we asked 3 Maj's CEO about the composition of the workforce (many of whom live in on-site, company-provided housing), he conceded that a large number of workers were not actually Croats. Many are from other parts of the ex-Yugoslavia, but there are also sizeable numbers from Slovakia and other countries. Croatia increasingly lacks the skilled workers it needs in trades such as welding to keep its shipyards running so, in addition to importing the ships' steel, it is importing labor.

Running onto the Shoal of the EU Acquis

17. The Croatia government doles out hundreds of millions of dollars in annual subsidies to the shipbuilding industry. It is a value-destroying exercise that has gone on for years. However, now that Croatia is in negotiations for EU membership, time is running out. The Commission has told the government that further subsidies can only be given within the context of a restructuring plan designed to bring the industry to profitability. The GOC hired a consultant whose recommendations have not yet been made public, but already the government is denying that it will shut down any of the yards. The most that seems likely to happen is that it will privatize the Uljanik yard in Pula (the healthiest of the shipyards that benefited from USAID assistance in restructuring). As the day of reckoning for the others is again delayed, state funds will again go to save what cannot be saved, crowding out other sorely needed investments.

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